Chapter 2
Indicators of the Province's Financial Condition

Contents

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Background

2.1 In 1997, a research report published by the Canadian Institute of Chartered Accountants (CICA) defined financial condition as a government's "financial health as measured by sustainability, vulnerability and flexibility, looked at in the context of the overall economic and financial environment."[1]

Scope

2.2 The purpose of this chapter is to provide readers with useful information about the Province's financial condition using the CICA research report as a guideline.

2.3 Though many potential indicators of sustainability, vulnerability and flexibility were considered in preparing the research report, only ten indicators were found which were relevant, necessary, measurable and clear to users of government financial information. Of these, our Office has concluded that six can be considered meaningful in the context of the Province of New Brunswick. They are:

Sustainability	• *Net debt as a percentage of gross domestic product (GDP)*
	• *Change in net debt and GDP*
Flexibility	• *Cost of servicing the public debt as a percentage of total revenue*
	• *Own source revenue as a percentage of GDP*
Vulnerability	• *Federal government transfers as a percentage of total revenue*
	• *Foreign currency debt as a percentage of total debt for provincial purposes*

Financial results used in analyses

2.4 In this chapter, our analysis is based on the current year financial statements as presented in the Public Accounts. Prior year numbers used in our analyses may include restated figures obtained from the Office of the Comptroller.

2.5 The 31 March 2000 financial statement expenditure figures include $903.8 million relating to the capital cost of the Fredericton to

1. *Indicators of Government Financial Condition*, 1997 published by the Canadian Institute of Chartered Accountants.

Moncton Highway. This adjustment results in a one-time increase in expenditure and a corresponding increase in net debt of $903.8 million in 2000.

Results in brief

2.6 In general, the five-year trends in sustainability, flexibility and vulnerability show that the Province of New Brunswick's financial condition has improved except for the proportion of federal government transfers to total provincial revenue (vulnerability).

2.7 The two-year trends in sustainability, flexibility and vulnerability are not as favourable as the five-year trends.

2.8 Some of the unfavourable impact on flexibility and sustainability shown by the two-year trend can be attributed to the adjustment in 2000 to record the capital cost of the Fredericton to Moncton highway.

Sustainability

2.9 Sustainability is the degree to which a government can maintain existing programs and meet existing creditor requirements without increasing the debt burden on the economy.[1]

2.10 It is now well understood by the general public that increases in the cost of servicing the public debt can directly impact the quantity and quality of programs and services to which the public has access. Accordingly many provinces, including New Brunswick, are striving to reduce their debt in order to ensure an optimum amount of funding is allocated to programs and services.

2.11 There are circumstances when governments may tolerate increases in their debt load. For example, when revenues are increasing, a higher cost of servicing the public debt might be tolerated without impacting existing programs and services. However, the ability to generate such revenues (e.g. through taxes, user fees, or licenses) is closely linked to the performance of the economy.

2.12 Therefore, any growth in New Brunswick's debt must remain in line with growth in the economy to ensure that our Province can sustain its programs and services. If debt is growing faster than the economy, New Brunswick will suffer reduced capacity for sustainability. Programs and services offered to the public may eventually suffer.

2.13 Gross Domestic Product (GDP) is the total value of all goods and services produced in the province during a specific period. GDP is often used to measure the growth of the economy.

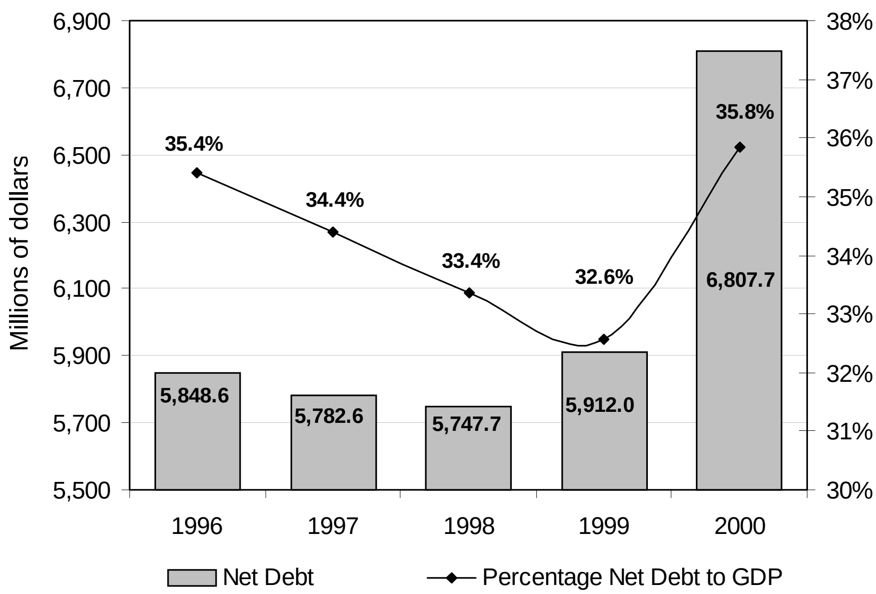
1. *Indicators of Government Financial Condition*, 1997 published by the Canadian Institute of Chartered Accountants.

Net debt as a percentage of GDP as a measure of sustainability

2.14 Net debt is an accounting measure of the extent to which total liabilities of the Province exceed financial assets. The net debt of the Province increases with deficits and decreases when surpluses are experienced. The financial statements for 2000 indicate that net debt stands at $6,807.7 million - $959.1 million more than its level five years ago.

2.15 However, the New Brunswick economy has also grown. Exhibit 2.1 shows that the Province's net debt to GDP ratio decreased (favourable) in the period 1996 to 1999 – showing the Province's increasing ability to sustain existing programs and services. In 2000, however, the growth in net debt exceeded growth in the economy (unfavourable) after the adjustment for the Fredericton to Moncton highway is considered. Excluding the effects of the Fredericton to Moncton highway, the five-year trend for this indicator is favourable.

Exhibit 2.1
Net debt as a percentage of GDP[1]
for the last five years



2.16 The 1999-00 provincial budget forecast called for nominal GDP growth to be 4.6% in 2000. Currently, the average of private sector forecasts of nominal 2000 GDP growth is 3.5%. Should these private sector forecasts be accurate the effect on our chart would be less favourable.

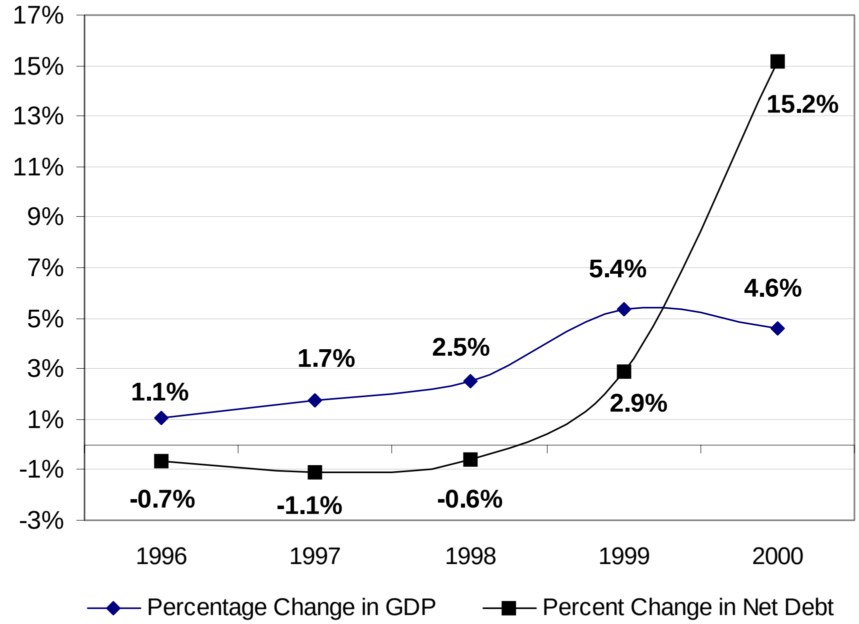
Change in net debt and GDP as a measure of sustainability

2.17 The Province can influence sustainability in two ways: by increasing surpluses (decreasing deficits) and by increasing growth in the economy. Though governments use various political, legislative and regulatory powers to stimulate the economy, the effect is neither guaranteed nor timely.

1. GDP information provided by N. B. Department of Finance.

2.18 The rate of growth in the surplus or deficit and their impact on net debt is much more controllable. Exhibit 2.2 shows that the Province experienced economic growth in excess of growth in the net debt (favourable) from 1996 to 1999. In 2000 there is a reversal in this trend because of the effects of the Fredericton to Moncton highway.

Exhibit 2.2
Change in net debt and GDP[1] for the last five years



Flexibility

2.19 Flexibility is the degree to which a government can increase its financial resources to respond to rising commitments, by either expanding its revenues or increasing its debt burden.[2]

2.20 Funding for programs and services is provided by either revenue or borrowing during the year. It is a useful measure of flexibility to know to what extent the Province is able to raise revenue from existing and potential sources should new commitments arise.

Own source revenue as a percentage of GDP as a measure of flexibility

2.21 One could assume that any additional funding for new programs or services might not be possible from existing revenue sources. A reasonable alternative would be to raise revenue from new provincial sources. However, the Province is only able to extract a finite amount of dollars from the economy of New Brunswick before the economy begins to falter. Though the exact capacity of the economy to bear such a burden is not known, one can determine the relative increase or decrease over time.

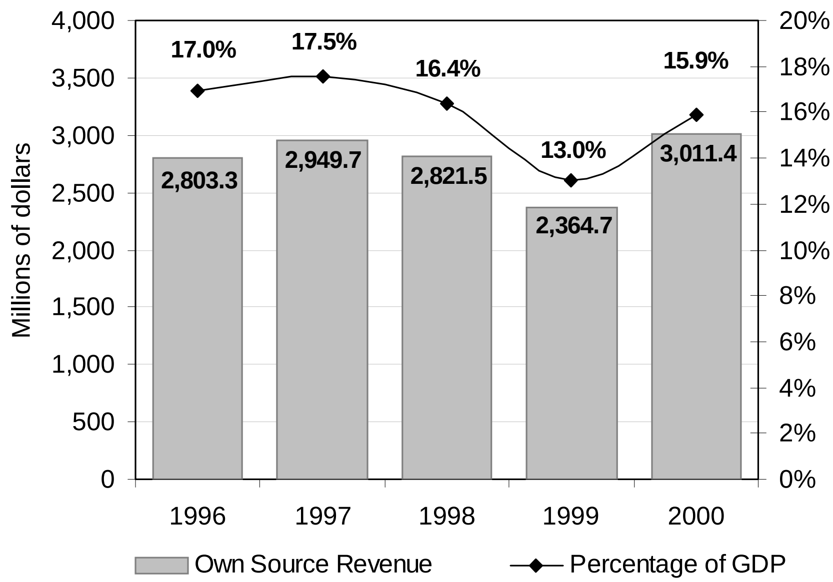
1. GDP information provided by N.B. Department of Finance.
2. *Indicators of Government Financial Condition*, 1997 published by the Canadian Institute of Chartered Accountants

2.22 Exhibit 2.3 shows the extent to which the Province has removed dollars from the provincial economy through taxes and user fees/licenses during the last five years.

2.23 This exhibit shows that the dollars extracted by the Province from the New Brunswick economy as a percent of GDP gradually decreased (favourable) from 1997 to 1999. This indicates an increase in flexibility. In 2000 this trend in provincial own-source revenue reversed (unfavourable) and in 2000 it stands at 15.9% of New Brunswick GDP. However, the percentage in 2000 remains lower than in 1996 through 1998 (favourable).

2.24 The large reduction in own-source revenue in 1999 was due to a $450 million one-time write-down in the Province's investment in the New Brunswick Power Corporation.

Exhibit 2.3
Own source revenue as a percentage of GDP[1] for the last five years



Cost of servicing the public debt as a percentage of total revenue (or "interest-bite") as a measure of flexibility

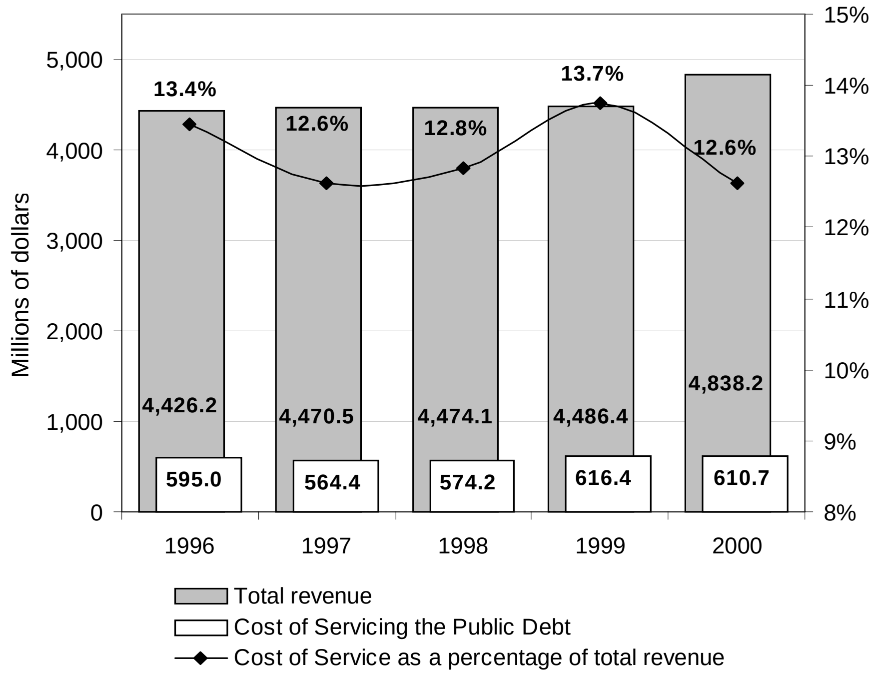
2.25 One of the most publicized factors which affects the flexibility of governments is the cost of servicing the public debt.

2.26 The cost of servicing the public debt is comprised mainly of interest on the funded debt of the Province. It also includes foreign exchange paid on interest and maturities during the year, the amortization of foreign exchange gains and losses, and the amortization of discounts and premiums which were incurred on the issuance of provincial debt. It does not include principal repayments on the funded debt of the Province.

1. GDP information provided by N. B. Department of Finance.

2.27 Exhibit 2.4 shows debt servicing costs as compared to total provincial revenue for the last five years.

Exhibit 2.4
Cost of servicing the public debt as a percentage of total revenue for the last five years



2.28 This exhibit shows the cost of servicing the public debt decreased in 2000 over 1999 but is only $6 million lower than its 1999 peak of $616.4 million. It also shows that the Province has decreased its overall "interest-bite" percentage from its 1996 level of 13.4% to its current level of 12.6%. This indicates that the Province has more of its total revenues available for current needs today than it did five years ago. Since 1998 there has been a decrease (favourable) in the cost of servicing the public debt as a percentage of total revenue.

Vulnerability

2.29 Vulnerability is the degree to which a government becomes dependent on, and therefore vulnerable to, sources of funding outside its control or influence, both domestic and international.[1]

2.30 Funding for programs and services can only come from two sources: revenue or borrowing.

Federal government transfers as a percentage of total revenue as a measure of vulnerability

2.31 In 2000, 38% of the Province's total revenue came from federal transfers. This is significant because revenue from federal sources is not considered to be as controllable as revenue generated in the Province.

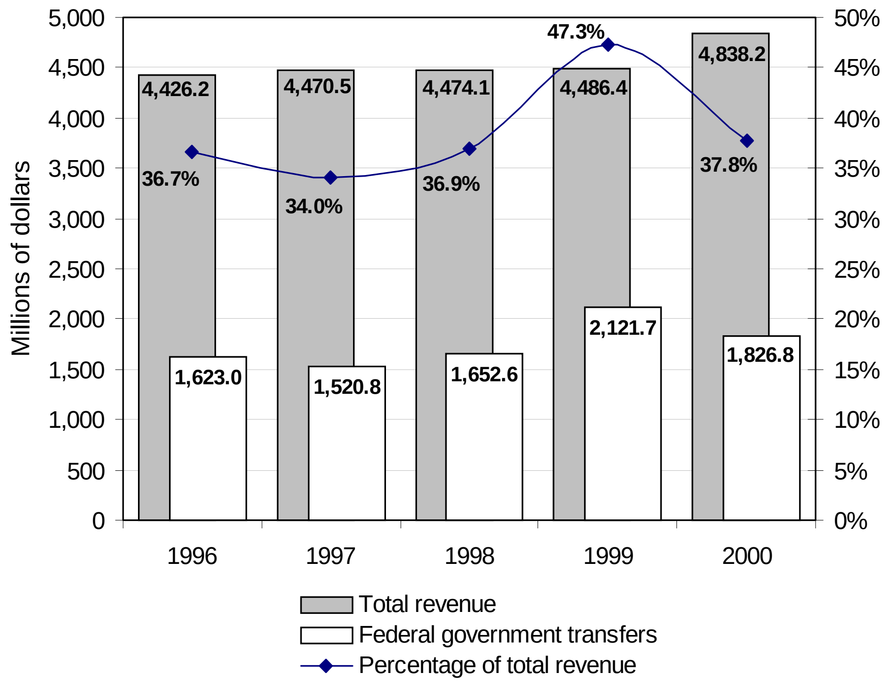
2.32 Own-source revenue is more controllable because the government can directly impact the amount generated using tax

1. *Indicators of Government Financial Condition*, 1997 published by the Canadian Institute of Chartered Accountants.

legislation as well as implementation or adjustment of user-fees/licensing rates. Federal transfers are subject to very different variables - few of which are under the jurisdiction of the provincial government. Federal fiscal policy decisions can severely impactprovincial governments by determining the amount and timing of future transfers.

2.33 Increasing New Brunswick's reliance on federal transfers will leave the Province more vulnerable to variables outside of its own control. Exhibit 2.5 details the Province's reliance on federal transfers over the last five years.

Exhibit 2.5
Federal government transfers as a percentage of total revenue for the last five years



2.34 This exhibit demonstrates that approximately 38 cents of each dollar of revenue received by the Province comes from the federal government. Though fluctuations have occurred over the last five years the trend has been generally unfavourable. In 2000 there has been a decline (favourable), although the percentage remains higher than in 1996 through 1998.

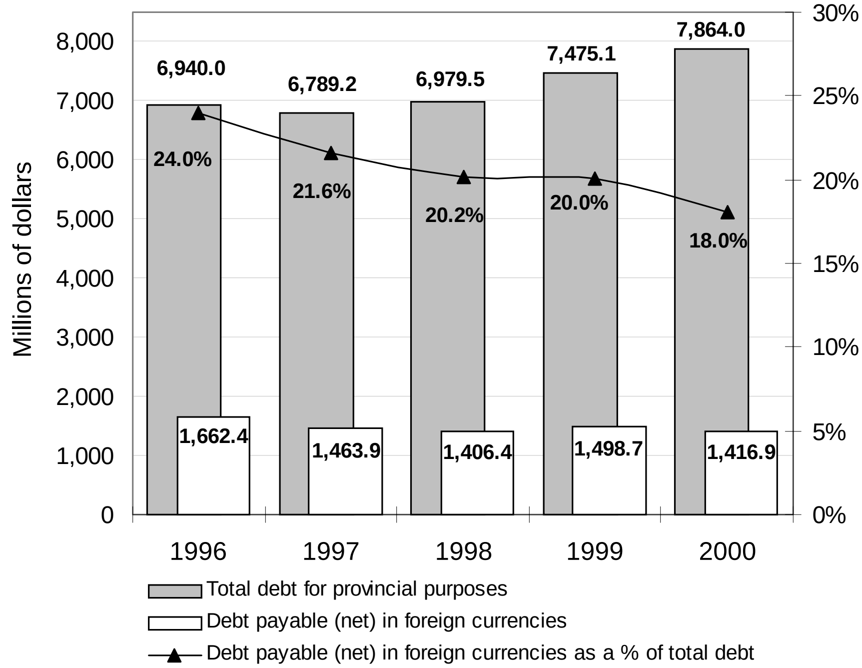
Foreign currency debt as a percentage of total debt for provincial purposes as a measure of vulnerability

2.35 When borrowing is required, there are choices to be made by the Province. For instance, if the Province chooses to issue its debt in a foreign currency instead of Canadian dollars, the Province will assume the risk of foreign exchange fluctuations. Such fluctuations can increase or decrease the amount ultimately payable in Canadian dollars for interest, and later, redemption of foreign currency debt.

2.36 Exhibit 2.6 shows the relationship of foreign currency debt to total debt for provincial purposes over the last five years. The Province has several alternatives to reduce (hedge) the risk associated with debt repayable in foreign currencies:

- purchasing assets denominated in foreign currencies for the Province's sinking fund;
- entering into debt swap agreements which allows repayment of the debt in Canadian dollars; and
- entering into forward contracts (which allow the Province to purchase foreign currency at a stipulated price on a specified future date).

Exhibit 2.6
Exposure to foreign currency risk for the last five years



2.37 The exhibit reflects the Province's exposure to foreign currency risk after eliminating the effect of hedges against foreign currency fluctuations.

2.38 The above exhibit demonstrates that the Province's vulnerability to foreign currency risk has declined (favourable) over the last five years. The overall exposure has decreased (favourable) from its 1996 level of 24% to 18% in 2000.

Summary

2.39 Exhibit 2.7 summarizes the financial indicators used in this chapter and outlines the impact of the two and five-year trends on the financial condition of the Province.

2.40 In general, the five-year trends in sustainability, flexibility and vulnerability show that the Province of New Brunswick's financial condition has improved. The only exception is federal government transfers as a percentage of total revenue.

2.41 The two-year trends for all of the indicators are not as favourable as the five-year trends. Some, although not all, of this impact is attributable to the required adjustments to net debt for the Fredericton to Moncton highway.

Exhibit 2.7
Summary of financial indicators

		Impact on Financial Condition of the Province	
Financial Indicator	**2000**	**2 year trend**	**5 year trend**
Sustainability			
Net debt as a percentage of GDP	35.8%	Unfavourable	Favourable
Change in net debt and GDP	15.2%/4.6%	Unfavourable	Favourable
Flexibility			
Own source revenue as a percentage of GDP	15.9%	Unfavourable	Favourable
Cost of servicing the public debt as a percentage of total revenue	12.6%	Favourable	No significant change
Vulnerability			
Federal government transfers as a percentage of total revenue	37.8%	Favourable	Unfavourable
Foreign currency debt as a percentage of total debt	18.0%	Favourable	Favourable